GuideStone® 2025 VANTAGE POINT

2024 Looked A Lot Like 2023

Once again, the U.S. economy avoided a recession and saw inflation fall, with financial markets posting another impressive year of returns.

Even though inflation remained higher than its target, the Federal Reserve went into rate-cutting mode, reducing the federal funds rate three times throughout the year. The looser monetary policy added extra fuel to the economy. The S&P 500® Index ended with back-to-back years of +20% returns, a feat that has only happened four times in history.

With higher prices still pressuring the consumer, President Donald Trump returning to the Oval Office and a world stage that looks more turbulent than ever, investors are wondering where we go from here. Here are some key risks, challenges and opportunities we're closely watching for 2025.

U.S. GLIDING TO A SOFT LANDING

Looking ahead to the rest of 2025, we expect the U.S. economy to continue its current glide path to a soft landing, where growth slows enough to curb inflation without causing a recession. While U.S. growth will likely slow, gross domestic product (GDP) is expected to remain resilient at 2% or higher. We believe the odds of a recession are low through the first half of this year but will gradually increase into 2026.

Several factors underpin our outlook. The U.S. consumer remains strong as disposable personal income continues to grow — albeit at a moderating pace — driven by wage increases and wealth transfers. Households are also maintaining healthy debt-to-income ratios. Additionally, the prospects of increased government efficiency, tax cuts and deregulation under the incoming

Trump administration — coupled with a Federal Reserve remaining in rate-cutting mode — should also support economic growth and corporate earnings.

Three transformational themes will define the economic landscape this year and beyond, bolstering opportunities for domestic growth. First, the rise of artificial intelligence (AI) will be a key driver of productivity. Second, infrastructure development and electrification will offer significant growth opportunities, as AI power needs put energy storage and grid modernization in the spotlight. Investments in renewable energy are also gaining momentum. Lastly, while the world is not moving to full deglobalization, shifts in supply chains, trade and national security investments will continue as geopolitical tensions remain high and potentially rise further.

FAVORABLE CONDITIONS FOR U.S. EQUITIES

The S&P 500® has historically delivered positive returns in the first year following elections. As previously noted, two consecutive years of +20% returns are rare. However, the last instance occurred during the 1990s' internet revolution, suggesting that technological innovation — such as today's AI advancements — can extend favorable market environments. We are moderately pro-risk U.S. equities, with the market poised to benefit from strong corporate earnings supported by favorable economic and policy conditions. Consensus expectations indicate corporate earnings will accelerate beyond 2024 levels, while the Federal Reserve's slow rate-cutting cycle historically favors risk assets. Additionally, deregulation often acts as a catalyst for bull markets.

The current market exhibits broadening strength for the year. The so-called "magnificent seven" tech giants (Apple®, Microsoft®, Amazon®, Alphabet®, Meta®, Nvidia® and Tesla®) have been crucial in driving S&P 500® growth. Still, momentum is building among the other companies as earnings growth outside the technology and mega-cap sectors is expected to narrow the gap. Small-cap earnings per share are also catching up to large caps, adding depth to the rally.

Despite these tailwinds, there are signs of potential moderation. U.S. equities are relatively expensive, and emerging signs of price exhaustion indicate a possible correction before new highs. Portfolio positioning is also at a bullish extreme, with institutional investors heavily overweight U.S. equities and net long positions at multi-decade highs. This leaves the market vulnerable; a hiccup in earnings or a weaker-than-expected economic report could trigger a sizable correction.

DISPERSION AMONG GLOBAL MARKETS

Throughout 2024, the major players in the international markets introduced policy stimulus measures, even though inflation remained above target. Easing global monetary policies and accelerating capital investments are expected to act as tailwinds for the worldwide economy. However, the potential for new U.S. tariffs under the Trump administration weighs heavily on global growth, particularly for China. Deglobalization pressures also threaten to dampen international markets, with shifting supply chains and trade disruptions becoming persistent challenges. This year, we expect to see regional markets diverge.

In Europe, energy prices have fallen but remain higher than in the U.S., putting upward pressure on costs. European growth picked up last year, though market share gains by China tempered some of the region's momentum. We anticipate Europe narrowly avoiding a recession and continuing its uneven recovery, supported by modest growth momentum. However, structural and trade-related challenges will likely persist, leaving Europe underperforming relative to the S&P 500®.

In Asia, growth will likely diverge across countries. India and Indonesia are expected to lead the region, driven by strong earnings growth and economic momentum. In contrast, China faces headwinds from potential tariffs, a lingering housing crisis, and other country-specific challenges, though its stimulus measures could support emerging market equities and global growth. Japan shows promise for moderate growth, fueled by increased consumption, strengthening wage growth and continued low inflation supported by looser monetary policies.

SOLID POTENTIAL FOR FIXED INCOME

Since the rate cut cycle began, bond yields have decreased from their highs in 2024 but remain above historical averages. This year, we expect bond yields to gradually trend closer to their long-run averages. At the same time, credit spreads are likely to remain tight, reflecting continued investor confidence in the fixed income market. Credit issuance is likely to strengthen as the economy grows, as well.

This year, the potential for positive absolute returns in fixed income is high, with total return opportunities available across the bond spectrum. Investment-grade bonds should offer attractive yields and the potential for capital appreciation, delivering solid returns across various monetary policy scenarios. Recall that the primary determinant of a bond's total return is highly predicated on its starting yield.

For more risk-tolerant investors, high-yield bonds could present an opportunity to achieve strong risk-adjusted returns through selective positioning. Also, emerging market debt may provide valuable diversification benefits, particularly in regions like Asia and Latin America, which are poised for growth. These factors make fixed income a compelling option for balanced portfolios in 2025.

Given the elevated valuations in equity markets, fixed income could serve as a valuable protective asset, particularly in a market correction.

RISKS TO WATCH

In the U.S., disinflation has stalled, and there is a lingering risk of a second wave of inflation. In particular, tighter immigration policies could limit the availability of foreign workers. Fewer workers, combined with strong demand, could lead to inflationary pressures. Additionally, high equity valuations and low credit spreads leave the market vulnerable to a painful correction.

Globally, Europe could drag growth and investment returns, while protectionist policies risk escalating to levels that may derail the economy and markets, leading to lower growth and higher inflation.

Government debt, particularly in the U.S. and other major economies, remains a significant long-term concern, weighing heavily on future economic prospects.

Finally, geopolitical risks add to market uncertainty. The fall of the Assad regime in Syria has created further instability in an already volatile Middle East. Iran is reeling from the loss of its Syrian ally and recent Israeli attacks. Russia continues to grapple with its prolonged war in Ukraine. In this environment, both Iran and Russia may feel cornered, increasing the likelihood of unpredictable or irrational actions. This geopolitical turmoil poses considerable risks to global stability and markets in 2025.

In conclusion, we see additional upside potential for financial markets, supported by improved U.S. productivity, that could contribute to global growth. However, the U.S. policy environment and ongoing geopolitical tensions will be key factors shaping outcomes this year.

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